

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:WR:SCA:LN:GL-802045-99

NKHoang

date: JAN 30 2001

to: Technical Support, Territory West

attn: J.Carr, Territory Manager  
S. Lutkenhouse, Revenue Officer

from: Associate Area Counsel, Area 8, SBSE, Laguna Niguel

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subject: Discharge of Federal Tax Lien After a Nonjudicial Foreclosure Sale  
Taxpayers: [REDACTED] ([REDACTED])

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on recipient and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

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(1) In determining the value of the Government's interest in property where the Service was not given proper notice of the foreclosure sale, should the Service consider the seller's reasonable sale expenses for the foreclosure sale?

(2) In determining the value of the Government's interest in property where the Service was not given proper notice of the

foreclosure sale, should the Service consider the seller's reasonable sale expenses for the sale subsequent to the foreclosure sale (the "Second Sale")?

(3) Does the sublessor's claim to accrued but unpaid Land Lease Payments have priority over the Federal tax lien, where under the Sublease, the sublessee is obligated to make monthly rental payments ("Land Lease Payments") in the amount of \$ [REDACTED] per month?

(4) Was the sublessor required to take actions to perfect its claim for the delinquent Land Lease Payments?

### CONCLUSIONS

In determining the value of the Government's interest in property where the Service was not properly given notice of the foreclosure sale, the Service should consider the seller's reasonable sale expenses for both the foreclosure sale and the Second Sale. The mortgagee was the seller in both the foreclosure sale and the Second Sale. The mortgagee's priority extends to reasonable expenses of sale for the foreclosure sale pursuant to I.R.C. § 6323(e), regardless of the fact that the Service was not given proper notice of the foreclosure sale. In the case of the Second Sale, the mortgagee's lien remained on the subleasehold property because it qualifies under an equitable exception to the merger doctrine. Upon discharge of the subleasehold property, the Service must consider the seller's reasonable sale expenses for the Second Sale pursuant to Treasury Regulation § 301.6325-1(b)(3), regardless of the fact that the Service was not given proper notice of the foreclosure sale. Before the United States can satisfy its lien or claim, the reasonable and necessary expenses of the Second Sale must be paid by the applicant of the certificate of discharge, or payment must be made from the proceeds of sale.

The sublessor's claim to the accrued but unpaid Land Lease Payments has priority over the Federal tax lien.

Since preservation of the leasehold interest is contingent on the payment of delinquent Land Lease Payments, the sublessor need ~~not take actions to perfect its claim. To collect under this~~ claim, the sublessor could simply terminate the sublease that created the leasehold interest.

### FACTS

The facts recited herein have been provided by your office; we have made no independent investigation of their accuracy. If you become aware of any change in these facts, you should not rely on

this advice and should seek additional assistance from our office.

██████████ (hereinafter "██████████") and ██████████ owe individual income taxes for taxable year ██████████. The taxes were assessed on ██████████.

██████████ (sublessor) and ██████████ (sublessee) entered into an agreement titled Sublease of Condominium and Grant Deed of Improvements (the "Sublease"). The Sublease was recorded on ██████████. Pursuant to the Sublease, ██████████ acquired a subleasehold interest in a condominium unit. In addition, he acquired an undivided ██████████ (██████████) interest as a tenant in common in a subleasehold estate in the condominium unit land lot and common areas. The subleasehold property is located at ██████████. The term of the Sublease is for a period of ██████████.

Under the Sublease, the sublessee is obligated to make monthly rental payments ("Land Lease Payments") in the amount of \$ ██████████ per month. This amount is the same as the land lease payment mentioned in your Request for Counsel Opinion Memorandum. The amount is subject to adjustment over the term of the Sublease.

According to the terms of the Sublease, if the sublessee defaults in the payment of the Land Lease Payment, the sublessor will serve written notice on the sublessee. If the default remains uncured for 60 days from the date of service of written notice, the sublessor is entitled to terminate or cancel the Sublease by giving the Sublessee written notice of the termination or cancellation.

██████████ took out a mortgage in the amount of \$ ██████████ to finance the purchase of his property interest. The lender, ██████████, recorded a deed of trust in the amount of \$ ██████████ against the subleasehold property on ██████████. Subsequently, ██████████ assigned its rights under the Deed of Trust to ██████████, as Trustee for the Registered Holders of ██████████ ("██████████"). The Assignment of Deed of Trust was recorded on ██████████.

██████████ assigned its interests as sublessor to ██████████ ("██████████").

A Notice of Federal Tax Lien against ██████████ was recorded with the Orange County Recorder's Office on ██████████, as instrument number ██████████. In accordance with I.R.C. § 6321, this lien attached to ██████████'s interest in the subleasehold property.

██████████'s subleasehold property was also encumbered by other

liens. Liens stemming from abstracts of judgment were recorded on [REDACTED], [REDACTED], [REDACTED], [REDACTED], and [REDACTED]. The Homeowner's Association recorded a lien against this property on [REDACTED]. A Franchise Tax Board Lien was recorded on [REDACTED]. These liens are all inferior to [REDACTED]'s security interest.

[REDACTED] foreclosed on [REDACTED]'s subleasehold property. A Trustee's Sale occurred on [REDACTED]. At the Trustee's Sale, [REDACTED] placed the highest bid and bought [REDACTED]'s subleasehold property for \$ [REDACTED], the amount of unpaid debt owed to [REDACTED]. The IRS was not given proper notice of the Trustee's Sale pursuant to I.R.C. § 7425(c)(1). [REDACTED] is currently in the process of selling the subleasehold property to a buyer for \$ [REDACTED]. A request for a Certificate of Discharge of Property from Federal Tax Lien was submitted to the IRS. In this case, the I.R.S. will likely discharge the property by substitution of proceeds of sale.

[REDACTED] was delinquent in making Land Lease Payments to the sublessor for the period extending from [REDACTED] through the end of [REDACTED].

## ANALYSIS

### Preliminary Issues

When any person liable to pay Federal income tax neglects or refuses to pay the tax after notice and demand, a lien in favor of the United States arises against all property or rights to property of such person. I.R.C. § 6321. A leasehold interest is a right to property that will terminate after a specified number of years. As long as the terminating event has not occurred, the leasehold interest is subject to the Federal tax lien. U.S. v. United Banks of Denver, 542 F.2d 819(10th Cir. 1976). The tax lien would also terminate upon the expiration of the lease. Carolina Apartment Investors "A" v. U.S., 77-1 USTC ¶ 9262 (E.D. Cal. 1977). In this case, the sublessor never terminated the leasehold agreement before the foreclosure sale; in addition, the lease had not expired before the sale. Thus, depending on the priority of its security interest, the United States may be entitled to a portion of the equity on the leasehold interest.

According to I.R.C. § 7425(b)(1), in a non-judicial sale, a Federal tax lien remains undisturbed if notice of the lien was recorded more than 30 days before the sale, and the United States is not given proper notice in accordance with I.R.C. § 7425(c)(1). Here, the Notice of Federal Tax Lien was recorded on [REDACTED]. The Trustee's Sale occurred more than thirty days after

██████████, on ██████████. No notice was given to the Secretary, in writing, by personal service or registered or certified mail, not less than 25 days prior to the sale. Thus, the Federal tax lien remains undisturbed. Subject to rules of priority, the Government may be entitled to a portion of the equity on ██████████'s leasehold interest.

### Issue 1

In determining the value of the Government's interest in property where the Service was not properly given notice of the foreclosure sale, should the Service consider the seller's reasonable sale expenses for the foreclosure sale?

If a holder of a security interest which has priority over a Federal tax lien incurs reasonable expenses to collect or enforce the obligation secured, those expenses enjoy the same priority as the holder's claim for the principal due under the security interest to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates. I.R.C. § 6323 (e)(3); Treas. Reg. § 301.6323(e)-1(a)(3). Reasonable expenses to collect or enforce the obligation secured include reasonable expenses incurred in collecting by foreclosure. Treas. Reg. § 301.6323(e)-1(b).

The statutory and regulatory provisions dealing with I.R.C. § 6323 are not qualified by any requirement that notice of the foreclosure sale must be properly given to the Secretary in accordance with I.R.C. § 7425(c)(1).

In this case, ██████████'s security interest has priority over the Federal tax lien. Section 6322 of the Internal Revenue Code states that unless another date is specifically fixed by the law, the lien imposed by I.R.C. § 6321 shall arise at the time the assessment is made. The assessment was made on ██████████. ██████████ borrowed \$██████████ from ██████████ (with rights assigned to ██████████) well before the Federal tax lien arose. In addition, the deed of trust in favor of ██████████ (with rights assigned to ██████████) was recorded well before the assessment date, on ██████████. The obligation arose before the assessment was made, and the deed of trust was perfected under local law before the creation of the Federal tax lien. In United States v. McDermott, 507 U.S. 447, 113 S.Ct. 1526 (1993), the United States Supreme Court addressed the issue of competing priorities between perfected federal tax liens and other perfected liens. In that case, the Court determined that priority for purposes of federal law is governed by the common-law principle that the "first in time is the first in right." In McDermott, the Court held that a competing state lien is deemed to be in existence for "first in

time" purposes only when it has been "perfected" in the sense that "the identity of the lienor, the property subject to the lien, and the amount of the lien are established." Id. In California, the lien of the mortgage is created and attaches upon the execution and delivery of the mortgage. Boye v. Boemer, 38 Cal. App. 2d (1940); Ukiah v. Petaluma Savings Bank, 100 Cal. 590 (1893). Assuming that the mortgage was a valid agreement that was properly executed and delivered, [REDACTED]'s claim has priority over the Federal tax lien.

Under California Civil Code § 2924d(a), a mortgagee may demand and receive from the mortgagor, or any other person having a subordinate lien or encumbrance of record, reasonable costs and expenses incurred in enforcing the terms of the obligation. In addition, California Civil Code § 2924d(b), states that upon the sale of property, a trustee may deduct from the proceeds of sale, those reasonable costs and expenses which are actually incurred in enforcing the terms of the obligation. Here, under California law, [REDACTED] (the mortgagee) may demand and receive reasonable costs of the sale from [REDACTED] (the mortgagor) or any other person having a subordinate lien (e.g., the Federal government). Thus, under local law, the reasonable expenses of the foreclosure sale enjoy the same priority as [REDACTED]'s security interest.

Thus, in determining the value of the Government's interest in property where the Service was not given proper notice of the foreclosure sale, the Service should consider the seller's reasonable sale expenses. In this case, [REDACTED]'s priority extends to its reasonable sale expenses pursuant to I.R.C. § 6323(e), regardless of the fact that the Service was not given proper notice of the foreclosure sale.

## Issue 2

In determining the value of the Government's interest in property where the Service was not properly given notice of the foreclosure sale, should the Service consider the seller's reasonable sale expenses for the Second Sale?

State law governs in the determination of whether [REDACTED] maintained its interest in the subleasehold property after the foreclosure sale. Aquilino v. United States, 363 U.S. 509 (1960). Under California law, the general rule is that a mortgagee's lien is extinguished when the mortgagee purchases the property to which its lien is attached. Cal. Civ. Code § 2910 (West 1974). This rule is based on the theory that the mortgagee's lesser interest (the lien) "merges" with the greater interest (the subleasehold interest). First American Title Insurance Co. v. United States, 848 F.2d 969 (9<sup>th</sup> Cir. 1988).

However, California law provides an equitable exception to the merger doctrine. First American Title Insurance Co. v. United States, 848 F.2d 969 (9<sup>th</sup> Cir. 1988); In re: Universal Farming Industries v. Thomen, 873 F. 2d 1334 (9<sup>th</sup> Cir. 1989); Ito v. Schiller, 213 Cal. 632 (1931); Jameson v. Alvinza, 106 Cal. 682 (1895); Strike v. Trans-West Discount Corporation, 92 Cal. App. 3d 735 (1979). In Jameson v. Alvinza, 106 Cal. 682, 688-689 (1895), the Supreme Court of California described this equitable exception:

"...equity will prevent or permit a merger, as will best subserve the purposes of justice, and the actual and just intention of the parties....And, in the absence of intention, or an expression of an intention, if the interest of the person whom the several estates have united, as shown from all the circumstances, would be best subserved by keeping them separate, the intent will ordinarily be implied."

Equitable relief is available to a mortgagee if all three of the following conditions are met: (1) the mortgagee's best interests would be best served by preventing a merger of the lien and the subleasehold interest; (2) the purposes of justice would be served; and (3) the government cannot prove by a preponderance of the evidence that the mortgagee actually intended to merge the lien into the subleasehold interest. First American Title Insurance Co. v. United States, 848 F.2d 969 (9<sup>th</sup> Cir. 1988).

In this case, it is clear that [REDACTED]'s best interests would be best served by preventing a merger of the lien and the subleasehold property. After the foreclosure sale, [REDACTED] can maintain its interest in the property and priority only if a merger was prevented.

To determine whether the purposes of justice would be served by allowing the mortgagee's lien to survive the sale, we would consider how preventing a merger would affect the interests of the mortgagee and the Government. Id. If equitable relief is not granted, [REDACTED] would lose \$ [REDACTED]. The Government, on the other hand, would receive proceeds which it otherwise would not have received had [REDACTED] notified it of the sale. If [REDACTED] had notified the Government, the Government's junior lien would have been extinguished. Moreover, if [REDACTED] had sold the property to another buyer at the foreclosure sale, or the Government had foreclosed on it, the proceeds from the sale would first go towards satisfaction of [REDACTED]'s lien and any remaining proceeds would go toward satisfaction of the Government's lien. The Court in First American Title noted that I.R.C. § 7425(b)(1) eliminates virtually any harm that the Government may suffer when it does not receive notice of sale because the Federal

tax lien would remain on the property. Id. The First American Title Court reasoned that, in this type of situation, the purposes of justice would be served if equitable relief were granted to the mortgagee. Id. The implication is that the Government would be unjustly enriched if equitable relief was unavailable to the mortgagee.

The file does not indicate that [REDACTED] expressed any intention on the merger issue. In this instance, equity will presume that [REDACTED] did not intend to merge its lien with the subleasehold interest if two of the following conditions are met: (1) [REDACTED]'s best interests would be served by preventing the merger, and (2) the purposes of justice would be served. Id. As discussed above, [REDACTED] fulfills both conditions. This presumption is rebuttable if the Government can prove by a preponderance of the evidence that [REDACTED] actually intended to merge its interests. See Sheldon v. La Brea Materials, 216 Cal. 686 (1932) (merger rule not applied when no direct or circumstantial evidence of an express intention to merge); see also Strike v. Trans-West Discount Corporation, 92 Cal. App. 3d 735 (1979) (placing burden of proof on person arguing that merger occurred). In this case, there is no evidence in the file that [REDACTED] actually intended to merge the interests.

Thus, in the case at hand, [REDACTED] would qualify for equitable relief under California law. Equity will prevent the merger of [REDACTED]'s interests, and [REDACTED]'s lien will survive the foreclosure sale regardless of the fact that it did not properly notify the Government of the foreclosure sale pursuant to I.R.C. § 7425(c)(1). First American Title Insurance Co. v. United States, 848 F.2d 969 (9<sup>th</sup> Cir. 1988).

As a consequence, the priority of [REDACTED]'s lien remains superior to the priority of our Federal tax lien.

In this case, the IRS will likely opt to discharge the property by substitution of proceeds of sale. Treasury Regulation § 301.6325-1(b)(3) states the following:

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"A district director may, in his discretion, issue a certificate of discharge of any part of the property subject to a lien imposed under chapter 64 of the Code if such part of the property is sold and, pursuant to a written agreement with the district director, the proceeds of the sale are held, as a fund subject to the liens and claims of the United States, in the same manner and with the same priority as the lien or claim had with respect to the discharged property. This subparagraph does not apply unless the sale divests the taxpayer of



all right, title, and interest in the property sought to be discharged."

If the IRS discharges the property by substitution of proceeds of sale, Treasury Regulation § 301.6325-1(b)(3) clearly states that the IRS should consider the seller's reasonable sale expenses:

"Any reasonable and necessary expenses incurred in connection with the sale of the property and the administration of the sale proceeds shall be paid by the applicant or from the proceeds of the sale before satisfaction of any lien or claim of the United States."

This provision is not qualified by any requirement that notice of the foreclosure sale must be properly given to the Secretary in accordance with I.R.C. § 7425(c)(1). Moreover, this provision does not distinguish between expenses incurred for a foreclosure sale, or for a sale subsequent to the foreclosure sale. Thus, this provision is applicable to the Second Sale. Before the United States can satisfy its lien or claim, the reasonable and necessary expenses of the Second Sale must be paid by the applicant of the certificate of discharge, or payment must be made from the proceeds of sale.

Thus, in determining the value of the Government's interest in property where the Service was not given proper notice of the foreclosure sale, the Service must consider the seller's reasonable sale expenses for the Second Sale.

### Issue 3

Does the sublessor's claim to accrued but unpaid Land Lease Payments have priority over the Federal tax lien?

Section 6321 of the Internal Revenue Code states that a tax lien attaches to "all property and rights to property, whether real or personal belonging to [the taxpayer]." In other words, the tax lien can attach to the taxpayer's rights to property, but nothing beyond that interest. Aquilino v. United States, 363 U.S. 509 (1960). Here, the lien attaches to [REDACTED]'s subleasehold interest in the condominium unit, the condominium unit land lot, and common areas.

Where an obligation is incident to the property interest, that obligation takes priority over a tax lien. Chicago Mercantile Exchange v. United States, 840 F.2d 1352 (7th Cir. 1988). In Chicago Mercantile, the Service imposed a tax lien on the taxpayer's property, a seat on the Chicago Mercantile Exchange. The Service claimed that it was entitled to the gross proceeds of

the sale of the taxpayer's seat on the Exchange. However, GNP Commodities, Inc. ("GNP"), the clearing member of the exchange responsible for the taxpayer's trades, argued that the Service was only entitled to the net proceeds after the taxpayer's debt to GNP had been paid off. GNP did not have a perfected security interest with regard to the \$93,000 that the taxpayer owed to GNP. However, GNP argued that the same Chicago Mercantile Exchange rules that created the taxpayer's property interest also required the taxpayer to pay his debts to GNP. The Court sided with GNP. The Court reasoned that the taxpayer's property right was created with rules and conditions that created, defined, and limited the property interest. Under these rules, the taxpayer was required to pay its debt to GNP. These rules and conditions are "an incident of the property, not a lien on that property." Chicago Mercantile, at 1357. Thus, the taxpayer's obligation to GNP necessarily takes precedence over the Federal tax lien.

In this case, the maintenance of [REDACTED]'s leasehold interest was contingent on the regular and timely payment of the Land Lease Payment. Failure to pay the Land Lease Payment on a regular and timely basis would result in the default of the Sublease. If the default was not cured 60 days after written notice was served on the sublessee, the sublessor could terminate the Sublease. The termination of the Sublease would necessarily terminate [REDACTED]'s leasehold interest in the property. As in Chicago Mercantile, this condition is an incident of the property. Thus, the sublessee's obligation to the sublessor to make the Land Lease Payments takes precedence over the Federal tax lien.

It is worth noting that in United States of America v. 110-118 Riverside Tenants Corporation, 886 F.2d 514, (2nd Cir. N.Y. 1989), the Court of Appeals distinguished the ruling in Chicago Mercantile. The Court ruled that although an apartment corporation had a claim against the taxpayer for defaulted maintenance payments, the Government's property interest extended to the gross proceeds from the sale of the taxpayer's shares and the government was not liable for the maintenance payments. In Riverside Tenants, the taxpayer owned shares in an apartment co-op and was subject to a proprietary lease that specified that, in the event that the tenant defaulted on the lease by failing to make maintenance payments, the lease would expire, and the tenant would have to surrender his shares in the co-op. In Riverside Tenants, the Court ruled in favor of the Government primarily because, at the time the Service imposed its tax lien, there had been no default by the taxpayer, and no indebtedness due to the Apartment Corporation. The Court noted that the Government had already been awarded judgment in District Court and moved to foreclose on the lien before the taxpayer incurred indebtedness and defaulted on the maintenance payments.

Riverside Tenants is distinguishable from the case at hand. Here, the Government had not been awarded judgment and no foreclosure on the tax lien had occurred before [REDACTED] defaulted on the Land Lease Payments.

Issue 4

Was the sublessor required to take actions to perfect its claim for the delinquent Land Lease Payments?

In Chicago Mercantile, supra, the Court stated that where an obligation is incident to the property interest, the issue is not whether an unperfected security interest prevails over a properly filed tax lien. Instead, the issue is whether an obligation that is incident to the property interest takes priority over a Federal tax lien.

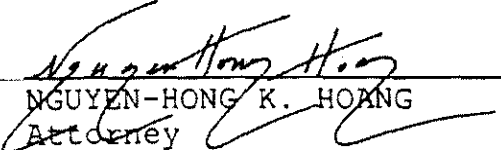
Like GNP in Chicago Mercantile, the sublessor in this case has an unperfected interest in accrued but unpaid Land Lease Payments. Regardless of the unperfected nature of the interest, the obligation still takes priority over a Federal tax lien because it is incident to the property interest. The obligation is "an incident of the property, not a lien on the property." Chicago Mercantile, at 1357.

Thus, the sublessor in this case was not required to take actions to perfect its claim for the delinquent Land Lease Payments.

If you have any further questions, please call attorney Nguyen-Hong K. Hoang at (949) 360-3465. We will be closing our file at this time.

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By:

  
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